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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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Federal Communications Commission
Office of Secretary

In the Matter of IMPLEMENTATION OF THE TELECOMMUNICATIONS ACT OF 1996: ACCOUNTING SAFEGUARDS UNDER THE TELECOMMUNICATIONS ACT OF 1996	CC Docket No. 96-150

COMMENTS OF THE TELECOMMUNICATIONS RESELLERS ASSOCIATION

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COMMENTS OF THE TELECOMMUNICATIONS RESELLERS ASSOCIATION

The Telecommunications Resellers Association ("TRA"), through undersigned counsel and pursuant to Section 1.429(f) of the Commission's Rules, 47 C.F.R. § 1.429(f), hereby responds to petitions for reconsideration[1] of the Report and Order, FCC 96-490, released by the Commission in the captioned docket on December 24, 1996 (the "Report and Order").[2] In the Report and Order, the Commission, pursuant to Sections 260 and 271 through 276 of the Communications Act of 1934,[3] as amended by the Telecommunications Act of 1996,[4] adopted

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[1] Petitions for Reconsideration have been filed by the American Public Communications Council ("APCC"), Ameritech, Cincinnati Bell Telephone Company ("CBT"), Cox Communications, Inc. ("Cox"), GTE Service Corporation ("GTE"), MCI Telecommunications Corporation ("MCI"), Southern New England Telephone Company ("SNET"), and SBC Communications Inc. ("SBC").

[2] Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996 (Report and Order), CC Docket No. 96-150, FCC 96-490, 11 FCC Rcd. 17539 (Dec. 24, 1996).

[3] 47 U.S.C. §§ 260, 271 - 276.

[4] Pub. L. No. 104-104, 110 Stat. 56, § 151 (1996).

accounting safeguards applicable to affiliate transactions by incumbent local exchange carriers ("ILECs"), including the Bell Operating Companies ("BOCs"), and governing the allocation of costs incurred by such carriers in the provision of both regulated telecommunications and nonregulated services.

In its Comments in this proceeding, TRA proffered the following recommendations with respect to the accounting safeguards mandated by Sections 260 and 271 through 276:

- The Part 32 affiliate transactions rules should apply to all transactions between a BOC and an affiliate "to ensure that these services are not subsidized by subscribers to regulated telecommunications services."

- All transactions between a BOC and its affiliates, as well as all transactions between ILECs and their affiliates, should comply with Generally Accept Accounting Principles ("GAAP").

- Internet access alone should not satisfy Section 272(b)(5)'s "public availability" requirement. Written accounts of all affiliate transactions should be submitted to the Commission and made available for public inspection.

- "Transactions", as that term is used in Section 272(b)(5), should be read to encompass "requests by an affiliate to its BOC for telephone exchange service or exchange access."

- Cost accounting rules should be modified to prescribe uniform treatment of valuation for both asset and services transfers, and to eliminate valuation based upon "prevailing price", consistent with Section 272(b)(5)'s mandate in favor of arm's length transactions.

- In support of their fair market value determinations, BOCs and ILECs should be required to subject all transactions capable of independent valuation to the mechanisms which will produce a reasonably accurate assessment of fair market value.

- The Commission should make clear that the preferred valuation method continues to be the tariff-based valuation process, and that resort to terms contained in either negotiated or arbitrated interconnection agreements or statements of generally available terms and conditions may only be had when no tariff-based evaluation may be undertaken.

- The Part 32 rules, as modified in this proceeding, should also apply to affiliate transactions between a BOC and its interLATA telecommunications services affiliate established pursuant to Section 272(a).

- The Commission should require that audits provide an accurate representation of whether the carrier has fulfilled its obligations under the 1996 Act, including the carrier's obligations pursuant to Section 272(e)(3) and (4).

- Regulated services outside the scope of local exchange and exchange access services provided on an integrated basis by a BOC must, at a minimum, remain subject to the Commission's cost allocation rules.

- The effectiveness of the Part 64 Rules would be enhanced by the Commission's treating as nonregulated all currently regulated BOC activities outside the scope of local exchange and exchange access services when those services are provided on an integrated basis.

- In order to effectuate the mandate of Section 272(e)(4), the rate which must be imputed to the BOC for provision of like services for its own internal operation must be the highest tariffed rate for those facilities or services.

Reconsideration of the Report and Order is sought by two BOCs -- *i.e.,* Ameritech and SBC -- and three other ILECs -- *i.e.*, CBT, GTE and SNET -- as well as MCI, Cox and APCC. The ILEC commenters all seek, to a greater or lesser degree, to ease the accounting safeguards adopted in the Report and Order; MCI, Cox and APCC all seek to strengthen these essential protections. TRA adamantly opposes any relaxation of the existing accounting safeguards, and, consistent with its earlier-filed Comments, generally supports strengthening these requirements as proposed by MCI.

I.

COMMENTS OPPOSING RECONSIDERATION

A. The Commission Should Retain and Not Expand the Single Exception Recognized by the Report and Order to the Valuation Requirements Imposed on the Provision of Services Between Carriers and Their Affiliates

In the Report and Order, the Commission conformed the valuation methods under the affiliate transactions rules for the provision of services to those methods used to value asset

transfers.[5] Previously, carriers had been permitted to record all service-related affiliate transactions that were neither tariffed nor subject to prevailing company prices at fully distributed costs, while asset-related affiliate transactions that were neither tariffed nor subject to prevailing company prices had to be recorded at the higher of cost or fair market value if the carrier was the seller, and at he lower of cost or fair market value if the carrier was the buyer.[6] Now, with one exception, carriers are required to use the same valuation method for both service and asset transfers.

The sole exception recognized by the Report and Order to this unitary valuation methodology involves instances in which "a carrier purchases from its affiliate services that are neither tariffed nor subject to prevailing company prices and such affiliate exists solely to provide services to members of the carrier's corporate family."[7] In this limited circumstance, the Commission allows the carrier to value the services provided by the affiliate at fully distributed cost.[8]

Ameritech, CBT and SNET all seek to expand this exception. Ameritech seeks to include within the exception services provided by a carrier to affiliates which exist solely to provide services to members of the carrier's corporate family.[9] CBT and SNET seek to expand

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[5] Report and Order, FCC 96-490 at ¶¶ 144 - 48.

[6] Separation of Costs of Regulated Telephone Service from Costs of Nonregulated Activities (Report and Order), 2 FCC Rcd 1298, ¶¶ 294 - 99 (1987) ("Joint Cost Order"), *recon.* 2 FCC Rcd 6283 ("Joint Cost Reconsideration Order"), *further recon.* 3 FCC Rcd 6701 (1988) ("Joint Cost Further Reconsideration Order"), *aff'd sub nom.* 896 F.2d 1378 (D.C. Cir. 1990)

[7] Report and Order, FCC 96-490 at ¶ 148 (emphasis in original).

[8] Id.

[9] Ameritech Petition at 1 - 5.

the exception to include all services provided by the carrier or its "parent holding company" exclusively to affiliates.[10] All of these ILEC commenters argue that such expansion of the exception is necessary to avoid "unnecessary administrative expense and artificially inflated costs."[11]

For its part, GTE broadly objects to market valuation of service-related transfers among carriers and their affiliates. Like Ameritech, CBT and SNET, GTE complains that the attendant costs and administrative burdens are excessive. Moreover, GTE contends that the additional protections are unnecessary and will produce no "countervailing benefits for the ratepayer."[12]

TRA urges the Commission to retain its unitary valuation scheme and to decline to expand the exception already afforded services purchased by a carrier from an affiliate which exists solely to provide services to members of the carrier's corporate family. The Commission has enumerated a number of persuasive reasons for requiring carriers to use the same valuation methods for both service and asset transfers involving affiliates. For example, the Commission explained that a requirement that service-related affiliate transactions be recorded at cost (if neither tariffed nor subject to prevailing company prices) "may reward a carrier that acts imprudently when buying services from affiliates for more than, and selling services to affiliates for less than, fair market value."[13] Such a result would have adverse ramifications for both ratepayers and unaffiliated service providers. Ratepayers would be harmed "if the carrier's

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[10] CBT Petition at 1 - 5; SNET Petition at 1 - 5.

[11] Ameritech Petition at 3.

[12] GTE Petition at 14 -20.

[13] Report and Order, FCC 96-490 at ¶ 145.

smaller profits or increased costs as a result of [the Commission's] valuation rules [were] reflected in rates for regulated telecommunications services."[14] Unaffiliated service providers (and indirectly ratepayers) would be harmed "if the valuation methods for affiliate transactions induce[d] carriers and their affiliates to 'use services that [were] not competitive to subsidize services that are subject to competition,' thereby putting service providers not affiliated with the carrier at a competitive disadvantage."[15]

Emphasizing the benefits of a unitary valuation scheme, the Commission also noted that it would reduce carriers' "incentive to record an affiliate transaction as a service transfer, rather than as an asset transfer, especially in the context of procurement activities."[16] As the Commission explained, under the old valuation regime, to the extent they characterized asset transfers as service transfer, carriers potentially could sell affiliates assets at less than market value or could acquire assets from affiliates at more than market value. "Requiring a carrier to value transfers of services using the same valuation methods . . . used for asset transfers would reduce a carrier's ability to value a transfer so that a carrier [could] pass on to their affiliates any financial advantages flowing from how they choose to characterize the transactions."[17]

Finally, the Commission pointed out that requiring carriers to record all affiliate transactions, including both service- and asset-related transactions, that are neither tariffed nor subject to prevailing company prices at the higher of cost or fair market value if the carrier is

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[14] Id.

[15] Id.

[16] Id. at ¶ 146

[17] Id.

the seller, and at the lower of cost or fair market value if the carrier is the buyer is fully consistent with statutory mandate that all affiliate transactions be conducted "on an arm's length basis."[18] As noted above, use of different valuation schemes for service and asset transfers allows for preferential treatment of affiliates. Moreover, different valuation schemes facilitate strategic manipulation of such transactions to prefer affiliates in violation of regulatory requirements.

Any regulatory requirement will have attendant administrative burdens and costs for the regulated entity. The issue hence is not whether regulation generates additional burdens and costs, but whether such burdens and costs are justified. Here, the Commission has clearly demonstrated the need for a unitary valuation mechanism, highlighting the multiple concerns the action is designed to address. Safeguarding consumer interests and competition constitutes ample justification for conforming valuation methods for asset- and service-related affiliate transactions.

While TRA does not object to the limited exception to the Commission's new unitary valuation regime recognized in the Report and Order, it strongly opposes any expansion of that exception. As crafted, the exception does not undermine the fundamental purpose for the Commission's action. If the exception were expanded as proposed by Ameritech, CBT and SNET, it would consume the rule, defeating that purpose. The key to the viability of the exception is its limitation to services acquired from affiliates established to provide service solely to the carrier's corporate family. As the Commission recognized, in this limited instance, "the benefits of . . . economies of scale and scope . . . reflected in . . . [the] affiliate's costs . . . are ultimately transferred to ratepayers through transactions with the carrier for . . . services valued

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[18] Id. at ¶ 147.

at fully distributed costs."[19] Ratepayers, accordingly, are not harmed and there is little threat of harm to unaffiliated service providers. This would not be the case if the exception were expanded to include carrier provision of services to affiliates; indeed, such an expanded exception would give rise to all the concerns the unitary valuation mechanism is designed to address.

B. The Commission Should Not Reduce the Percentage Threshold for Establishing a 'Prevailing Company Price"

In its Comments, TRA urged the Commission to eliminate the valuation of affiliate transactions based on prevailing company prices.[20] TRA argued that the prevailing price valuation method preferred carrier affiliates over unaffiliated entities and that given the complexity inherent in determining the prevailing price, use of prevailing prices constituted an open invitation to strategic price manipulation. With respect to the former, TRA emphasized that a carrier permitted to utilize a full "prevailing price" to account for transactions with affiliates would be able to transfer to the affiliate not only the asset or service that was the subject of the transaction, but avoided marketing and transactional costs as well. As TRA explained, a carrier transacting business with an affiliate would benefit from lower or non-existent marketing costs since the carrier would already be known to the affiliate, relieving the carrier of the need to expend funds to capture the affiliate's attention, acquaint the affiliate with the carrier's operations or otherwise "win over" the affiliate. As a result, transactional costs also would likely be minimized in affiliate transactions.[21]

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[19] Id. at ¶ 148.

[20] TRA Comments at 11 - 13.

[21] Id. at 11 - 12.

TRA further argued that prevailing prices could be strategically manipulated in the absence of adequate data. TRA stressed that where the percentage of third-party business was small, there would be little assurance that market activity would result in true "arm's length" transactions between carriers and affiliates. Moreover, TRA added, the highly specialized nature of an affiliate's products and services would hinder reasonable calculation of "prevailing prices."[22]

The Commission ultimately opted to retain prevailing company prices as a valuation method under its affiliate transactions rules. In so doing, however, the Commission acknowledged "difficulties in determining what is necessary to establish a prevailing price."[23] To address one of these difficulties -- *i.e.,* "determining when carriers should apply the prevailing price method to transfers of particular assets or services" -- the Commission mandated that "[a] substantial quantity of business must be conducted with unaffiliated third parties in order to establish a true prevailing price."[24] As the Commission explained, "if the percentage of third-party business is small, there can be no assurance that the price agreed upon by the carrier and its affiliate represents the true market price, thus raising legitimate questions as to whether the parties actually negotiated 'on an arm's length basis'."[25]

To address this articulated concern, the Commission quantified "substantial," providing "a clear definition of what constitutes prevailing price."[26] To this end, the Commission concluded that "annual sales, as measured by quantity, of greater than 50 percent of a particular

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[22] Id. at 12 - 13.

[23] Report and Order, FCC 96-490 at ¶ 133.

[24] Id. at ¶ 134.

[25] Id.

[26] Id.

product or service to third parties must occur to satisfy the requirement that there be a 'substantial' amount of outside business in order to produce a true prevailing price for that particular product or service."[27] GTE complains that this percentage threshold is excessive.[28]

TRA continues to believe that the public interest would be better served by elimination of prevailing company prices as a valuation mechanism for affiliate transactions. If carriers are to continue to have the option to record affiliate transactions at prevailing company prices, however, efforts must be made to constrain the strategic manipulation of this valuation mechanism. The percentage threshold adopted in the Report and Order is a critical safeguard. As the Commission found, use of prevailing company price valuation where no true prevailing price exists allows products and services to be valued by a carrier "at a fabricated prevailing price to the harm of ratepayers if the cost or market value of such products or services is actually different from this fabricated prevailing price."[29] To avoid this eventuality, the Commission established the fifty percent threshold, reasoning that "third-party sales of 50 percent or less are evidence of the fact that a party's primary function is to provide products or services to affiliates, rather than to outside market participants, and, consequentially, those sales to unaffiliated entities are not sufficient to establish a true prevailing price."[30]

TRA strongly urges the Commission not to increase the danger inherent in the use of prevailing company prices as a valuation mechanism by reducing the percentage threshold as suggested by GTE.

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[27] Id.

[28] GTE Petition at 11 - 14.

[29] Report and Order, FCC 96-490 at ¶ 136.

[30] Id. at ¶ 135.

II.

COMMENTS IN SUPPORT OF RECONSIDERATION

A. The Commission Should Reconsider the Broad Exception Afforded BOCs to the Prevailing Company Price Percentage Threshold

MCI has urged the Commission to reconsider the sole exception allowed to its rule that "only a product or service for which annual sales to third parties, measured by quantity sold, exceed 50 percent of total sales of that product or service may be recorded by carriers at prevailing prices."[31] The afore-referenced exception takes the form of a "rebuttable presumption" that the rates charged by BOCs to their Section 272 affiliates represent prevailing company prices. This rebuttable presumption is predicated on the statutory requirement that BOCs must make generally-available the rates charged their Section 272 affiliates for facilities, services and information.[32]

While the assumptions underlying the exception are logically-based, TRA agrees with MCI that there can be no assurance that the rates that BOCs charge their Section 272 affiliates will constitute a reliable measure of market value. Apart from the preliminary assumption that the BOCs will actually offer all services on a nondiscriminatory basis, MCI correctly points out that "many services provided by a BOC will have only the BOC's affiliates as potential customers."[33] Thus, MCI notes by way of example that "[m]ost marketing, research and development, and administrative services provided by a BOC would be tailored to the needs

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[31] Id. at ¶ 137.

[32] Id.

[33] MCI Petition at 2.

of the BOC's affiliates and would thus be useless to third-party customers."[34] And, MCI adds, the same is true for many asset transfers, highlighting the likely absence of bidders for a BOC's Official Services Networks.

A transaction between a BOC and an affiliate involving a service or asset for which the affiliate is the only interested buyer will likely not be conducted on an arm's length basis. Hence, the exception from the prevailing company price percentage threshold could create the very problems the percentage threshold was designed to prevent. MCI is correct, the exception should be eliminated and BOCs should only be permitted to record transactions at prevailing company prices in accordance with the generally-applicable rule.

[34] Id.

III.

CONCLUSION

By reason of the foregoing, the Telecommunications Resellers Association urges the Commission to reconsider its Report and Order consistent with these comments.

Respectfully submitted,

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